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# Taxation--Payments for Assignment or Cancellation of Contracts as Capital Gain or Ordinary Income

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## Notes and Comments

### TAXATION—PAYMENTS FOR ASSIGNMENT OR CANCELLATION OF CONTRACTS AS CAPITAL GAIN OR ORDINARY INCOME

Extensive litigation has arisen recently on the question whether the consideration received for the assignment or cancellation of contracts constitutes ordinary income or capital gains. In order to receive the more favorable treatment accorded long term capital gains two basic requirements of the statute must be met: (1) there must be a sale or exchange; and (2) the transaction must involve property which is a capital asset. The statute does not define a sale or exchange and defines a capital asset only in general terms.<sup>1</sup> Hence specific factual situations involving unusual types of property have been subject to litigation, and it is believed that some categorization of the different situations is discernible in the cases. The following discussion will attempt to analyze and fit into categories the different transactions involving assignments or cancellation of contract rights with regard to whether or not capital gains treatment will be given.<sup>2</sup> The point of departure is to recognize that while contracts are property, not all are capital assets, and the nature of the income that would normally result from the fulfillment of the terms of the contract may be one factor in the termination.<sup>3</sup>

*The lease contract.* A landlord was paid a lump sum by the tenant for cancellation of a long term lease. The court held that "The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises."<sup>4</sup> The case for capital

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<sup>1</sup> INT. REV. CODE 117 (a) (1). A capital asset is defined with specific exceptions, not here material, as property held by the taxpayer. INT. REV. CODE 113 (a) merely puts a tax on a sale or exchange without further defining the terms.

<sup>2</sup> However the division line between categories is not always so definite that the twain shall never meet; and even if this were true, the taxpayer would be very likely to have a fact situation which would not fit nicely into the definite category. Therefore, answers must be found by analogy. The task is then to analyze the categories and attempt to find one that is analogous to the fact situation in which the courts have allowed capital gains treatment.

<sup>3</sup> If the contract is equivalent to a right to receive income, the sale of the contract will not convert the consideration received for the contract into a capital asset. *Shumlin v. Commissioner*, 16 T. C. 407 (1951) (payment of a lump sum rather than royalties as a producer).

<sup>4</sup> *Hort v. Commissioner*, 313 U. S. 28, 32 (1941); But the owner of a life tenancy in trust has a property right which he may sell to the remainderman even though all his interest consists of is a right to receive income. *McAllister v. Commissioner*, 157 F. 2d 235 (2d Cir. 1946).

gains treatment failed because both requirements therefor were lacking. The contract right to receive income did not meet the statutory definition of a capital asset though it was valuable property.<sup>5</sup> Secondly, nothing was transferred to the tenant to constitute a sale or exchange; there was merely a cancellation.<sup>6</sup> But where a landlord paid a tenant to cancel, the consideration received by the tenant has been held to be a capital gain to the tenant.<sup>7</sup> The tenant's right to possession was a capital asset in his hands which could be transferred by a sale or exchange.<sup>8</sup>

*The employment contract.* E entered into an employment contract with a corporation. When the contract had run for two years, a third party made a secret agreement with the corporation to get the release of E from his contract with the corporation. This plan was carried out, and E was paid a lump sum of money for the cancellation of his contract. The court held that E's employment contract, concededly property in the constitutional sense in that it could not be arbitrarily legislated away, was not a capital asset for tax purposes because it was only a contingent right to receive compensation for services to be performed in the future. Furthermore, the court pointed out that there could not have been a sale because the contract was personal in nature and depended upon a particular person's skill in performing the services. Since no property was transferred, there was no sale but only a termination or cancellation of the contract.<sup>9</sup>

A fringe case which is on its facts more favorable to the taxpayer

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<sup>5</sup> Note the application of this principle in *Rhodes' Estate v. Commissioner*, 131 F. 2d 50 (6th Cir. 1952) where payment for the assignment of stock dividends declared but not paid yielded ordinary income to the assignor and likewise in *Helvering v. Eubank*, 311 U. S. 122 (1940) where an insurance agent assigned renewal commissions.

<sup>6</sup> Capital gains treatment has been denied in the following situations where agreements between the original parties have been made to cancel or extinguish an obligation: *Milliken v. Commissioner*, 15 T. C. 243 (1950) (option to purchase); *Bingham v. Commissioner*, 105 F. 2d 971 (2d Cir. 1939) (compromise and via dictum surrender of a promissory note); *Bodine v. Commissioner*, 103 F. 2d 982 (3rd Cir. 1939), *cert. den.* 308 U. S. 576 (1940) (surrender of insurance contracts); *Fairbanks v. United States*, 306 U. S. 436 (1939) (redemption of bonds before maturity, *but see* INT. REV. CODE sec. 117 (f) for present rule).

<sup>7</sup> *Commissioner v. Golonsky*, 16 T. C. 1450 (1951), *aff'd* 200 F. 2d 72 3rd Cir. 1952; *Ray v. Commissioner*, 18 T. C. 438 (1953); but the Commissioner has announced his nonacquiescence to *McCue Bros. and Drumond v. Commissioner*, 19 T. C. 667 (1953), 1953 INT. REV. BULL. No. 13 at 1, and see *Rev Rul 129*, 1953 INT. REV. BULL. No. 16 at 2.

<sup>8</sup> A transfer by the tenant to a third person for a profit also yields capital gains. *Sutliff v. Commissioner*, 46 B. T. A. 446 (1942).

<sup>9</sup> *McFall v. Commissioner*, 34 B. T. A. 108 (1936); *accord*, *Gann v. Commissioner*, 41 B. T. A. 388 (1940); and compensation for past services resolved into a contract of settlement is not a capital asset, *Shuster v. Helvering*, 42 B. T. A. 255 (1940), *aff'd* 121 F. 2d 643 (2d Cir. 1941); *Parker v. Commissioner*, 5 T. C. 1355 (1945).

is *Jessop v. Commissioner*.<sup>10</sup> There the taxpayer sold nearly all of the stock of a corporation which he owned to H in consideration of money plus an agreement by the buyer to secure employment for the seller with the corporation. Sometime after the employment contract was procured, relations became strained and he sold his contract back to the corporation, agreeing to refrain from engaging in the same type of business for three years. He contended that this contract was part of the consideration paid for the stock which he owned since the market value of the stock was far in excess of the amount of money paid for it. The court held that even though the employment contract was an inducement for the sale of the taxpayer's stock, it was not part of the consideration. This was a contract for personal services which had to be rendered before any compensation would be paid. Therefore, the taxpayer's receipts for his agreement to cancel his contract and not to engage in the same line of business for three years was ordinary income. It seems that the court considered the situation before it a covenant not to compete.

The *Gustav Hirsch* case<sup>11</sup> is presented to demonstrate how only a nuance in the fact situation may result in a court's finding capital gains rather than ordinary income. An agreement was formed between a corporation and B whereby B was to use his knowledge and efforts to obtain stock in certain corporations. All funds were advanced by the corporation and a holding company was to be created with B given a certain amount of stock. The holding company was never organized and the corporation paid B \$162,000 for his interest. The transaction was held to result in a capital gain. This was said to be in the nature of a joint adventure rather than compensation for services.

As to employment contracts, then, the essential point is that the courts will consider a sale or extinguishment between employer and employee, or even a third party, simply as an assignment of the right to receive income. The fact that such contracts are property in the constitutional sense does not mean that they are capital assets for tax purposes. The difficulty is said to be that the assignment of the right to receive income does not change the inherent nature of this right. Furthermore, it is asserted that one cannot assign a contract to perform personal services, because the services depend upon the skill of the particular person who has contracted to perform. Hence, there is no actual assignment, but really only a termination of the contract, so

<sup>10</sup> 16 T. C. 491 (1951); *accord*, *Becken v. Commissioner*, 5 T. C. 498 (1945).

<sup>11</sup> B. T. A. Memo Op. Dkts. 101478-9 (Jan. 30, 1942) as cited in 3 MERTENS, *INCOME TAXATION*, supplement 303 (1953); *But cf.* *Rosenberg v. Commissioner*, 15 T. C. 1 (1950), *Worm v. Commissioner*, 22 B. T. A. 36 (1931).

that no property reaches the transferee in order to satisfy the sale or exchange requirement. The fringe cases reveal that even though an employment contract was the inducement if not the consideration for a stock transfer, the contract is nothing more than a right to receive compensation for services to be performed in the future, and it will not be considered a capital asset. However, if the taxpayer is able to satisfy the court that he is more in the nature of a joint adventurer or partner than an employee his transaction may be given capital gains treatment.

*The covenant not to compete* is in the nature of a promise not to work for others or for one's self for a given period. This is the converse of a promise to work—it is a negative covenant. In *Cox v. Helvering*<sup>12</sup> A was the principal stockholder of a corporation which had been bought by Y. Y refused to carry out the purchase unless A would contract not to re-enter the ice business for ten years. A was paid \$15,000 in addition to the purchase price for the agreement not to compete. Held: A received \$15,000 ordinary income. What a person receives when he sells his services for wages or salary is clearly income. The courts have now said that what a person receives when he refrains from exercising his skill or ability in a particular line is likewise income because this is merely the converse of the employment contract and is essentially the same thing.<sup>13</sup> Since the Commissioner's position has become so firmly entrenched that an employment contract is not a capital asset for tax purposes, the Commissioner, with the aid of the courts, is prone to assert that any situation which is tainted with the flavor of an employer-employee relationship or the rendition of services falls into that empyrean category. In this respect the Commissioner and the courts have not overlooked the next category, the agency contract.

*The agency contract.* In *Jones v. Corbyn*<sup>14</sup> the taxpayer had an exclusive agency contract with a life insurance company. Difficulties arose and the agent agreed to terminate the contract for a consideration. The court held that the contract had substantial value, was capable of producing income for the owner, was enforceable at law, and had been the basis for the building up of a lucrative business through the personal efforts of the taxpayer. The effect of the termina-

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<sup>12</sup> 71 F. 2d 987 (D. C. Cir. 1934).

<sup>13</sup> For further illustration of this point see Kamens and Ancier, *Tax Consequences of a Covenant Not to Compete*, 27 Taxes 891 (1949).

<sup>14</sup> 186 F. 2d 450 (10th Cir. 1950); cf. *Jones v. U. S.*, 96 F. Supp. 973 (D. Colo. 1951), *aff'd* 194 F. 2d 783 (10th Cir. 1952) where an assignment of an interest in a franchise was allowed capital gains treatment though the franchise was leased and all that could be sold was a present right to receive income. *But cf. McCartney v. Commissioner*, 12 T. C. 320 (1949).

tion was to transfer the business to the insurance company, thus constituting a sale of a capital asset.

In *Smoak v. Commissioner*<sup>15</sup> A was the agent of a corporation for leasing machines which packaged milk in paper containers. A spent about \$25,000 in setting up an office and sales organization for the exclusive territory. Later the corporation merged with another which decided to do its own marketing and servicing, and the new corporation purchased A's contract. The court held that A had sold an agency business which consisted of all of the assets of the business among which was the agency contract. Therefore, the taxpayer was entitled to capital gains treatment.

But *Williams v. Commissioner*<sup>16</sup> manifests how meticulously one must fit his transaction into the established category which is favorable to the taxpayer.<sup>17</sup> In this case A was the general agent for a group of fire insurance companies. He agreed to cancel the contract for \$20,000. The court held that ordinary income was realized. A's contract with the insurance companies provided that he was not to become a general agent for five years and one year was left to run under the contract. The court said that since the full five years had not run, this was not a payment for his contractual rights. Rather this was a payment for services rendered by A under the contract.

The Court of Appeals for the Second Circuit in *Starr Brothers v. Commissioner*<sup>18</sup> seems to limit further the favorable rule laid down in *Jones v. Corbyn* and the *Smoak* case. In this case the owner of a retail store made a contract with United Drug Company whereby he was appointed the exclusive selling agent for United in a specified area. The agency contract did not create an employer-employee relationship. Later United paid the retailer over \$6,000 for agreeing to terminate the contract. This was held to be ordinary income. Notice that the retailer had not built his entire business around the agency contract, and he was not selling all of his business assets among which was the agency contract. Hence the court might have found that it did not fit into the favorable agency contract category and was not a capital asset. However, it admitted that the contract was valuable property and was a capital asset, but said that the decisive issue centered around the sale or exchange requirement. The contract was not sold but extinguished. To refer to the contract as a grant or a franchise

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<sup>15</sup> 43 B. T. A. 907 (1941).

<sup>16</sup> 5 T. C. 639 (1945).

<sup>17</sup> In dealing with tax cases greater care must be used than in other areas of the law in searching for a category which almost identically fits the fact situation with which one is dealing.

<sup>18</sup> 204 F. 2d 673 (2d Cir. 1953) reversing 18 T. C. 149 (1952).

would becloud the issue, because the promise was in effect a negative covenant by United not to sell its products to any other person in a specified area. There was a release of a negative covenant rather than a sale, and the income was ordinary.

The same court decided *General Artist Corp. v. Commissioner*.<sup>19</sup> In this case GA contracted with Frank Sinatra to become his exclusive booking agent for a certain period. GA had approximately 270 contracts with persons in the entertainment field during one year of the Sinatra contract, and it was not in the business of selling agency contracts. However GA entered into an agreement with MCA, another booking agent, which provided that GA "sells" to MCA its agency contracts with Sinatra which "shall be deemed to supersede, cancel and take the place of" contracts between Sinatra and GA. Sinatra signed the following endorsement:

"The undersigned is familiar with all of the terms, provisions and conditions contained in the above contract and agrees to be bound by the same and acknowledges that the undersigned's agreement is an inducement to the parties to enter into the above contract."<sup>20</sup> GA contended that it had sold a capital asset to MCA. But the court held that though the contract may have been a capital asset, its nature was that of a negative covenant which was released and hence it was bound by its own rule laid down in the *Starr Brothers* case. In both cases the agents performed selling services which were not necessarily personal services, hence there was not a strict employer-employee relationship. Nor had the taxpayer built his entire business on an agency contract which if terminated would destroy his business as in *Jones v. Corbyn*. It should be noted that the court in the *General Artist* and *Starr Brothers* cases was faced with facts which did not fit precisely into either the favorable agency contract or the employment contract categories. The facts seemed to lie some place midway between. Hence the Second Circuit Court of Appeals dipped into another category, the negative covenant, which had not hitherto been used in this environment. It had been held that where payment was received by a covenantor for his promise not to compete, this was ordinary income to the covenantor.<sup>21</sup> However, in *Starr Brothers* the converse was held to be income, that is, where a covenantee released the covenantor from his negative covenant.<sup>22</sup> But in *General Artists* the court went still further and held that even though the transaction was between the covenantee and a

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<sup>19</sup> 17 T. C. 1517 (1952), *aff'd* 205 F. 2d 360 (2d Cir. 1953).

<sup>20</sup> 17 T. C. 1517, 1520 (1952).

<sup>21</sup> *Supra* note 12; *supra* note 13 at 892.

<sup>22</sup> A series of analogous situations are set out in note 6 *supra*.

third person, it could qualify as a release of a negative covenant. Since the court reached its result by way of a technical interpretation of the sale or exchange requirement, its technical basis should be subjected to close scrutiny. Ordinarily courts have distinguished two types of transactions in regard to their satisfaction of the sale or exchange requirement. The first type is where the original parties to a contract agree to cancel, release, or surrender it. Examples are cancellation of a lease, termination of an option contract, and surrender of a promissory note. None of the foregoing transactions will ordinarily satisfy the sale or exchange requirement since no new rights are created and there is merely an extinguishment of former rights and duties.<sup>23</sup> The second type transaction is where the obligee in any of the release transactions gives up his rights in favor of a third person for a consideration paid by the third person to the obligee. Here the transaction is not prevented from being a sale or exchange.<sup>24</sup> When the transaction is not solely between the original parties to the contract, the substance of the transaction is vastly changed; and the distinguishing element is the creation of new rights in the third party. In *Starr Brothers* the court rightly concluded that the transaction was a release of rights and duties between the original parties and was not a sale or exchange, but it is doubtful if this approach is applicable to the facts in the *General Artist* case. There the court sought to rationalize its position by this statement:

It might be suggested that the instant case differs from that of *Starr Bros.* because the latter involved a release of a binding negative covenant to the obligor, whereas here there was a transfer to a third person of the rights under the covenant. But we think the correct view is that here there was a release to the obligor of a negative covenant in order to allow a new covenant. . . .<sup>25</sup>

However, in every assignment to a third party the contract right does not pass to the assignee. The technical procedure is that the assignor extinguishes his relations with others respecting the subject matter and creates similar but new relations with the assignee and others.<sup>26</sup> Thus

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<sup>23</sup> *Supra* note 6. But one obvious exception is where the consideration received by a tenant for cancelling his lease is treated as capital gains as pointed out by the case in note 7.

<sup>24</sup> *Sutliff v. Commissioner*, 46 B. T. A. 446 (1942) (transfer of a lease by a tenant to a third person); *McKee v. Commissioner*, 35 B. T. A. 239 (1937) (transfer of bonds to a third person); *G. C. M. 23677*, 1943 CUM. BULL. 370 (sale of an option contract to a third person).

<sup>25</sup> 205 F. 2d 360, 361 (2d Cir. 1953).

<sup>26</sup> "Alienation, conveyance, and transfer, therefore, consist of some operative action that extinguishes and creates, that substitutes a new party as the focus of legal relations with respect to the subject matter. Such also is an 'assignment' in the law of contracts." 4 CORBIN, CONTRACTS 422 (1951). Also see 2 WILLISTON, CONTRACTS 1165 (1936).



when the consideration moves from the third party to the obligee, it is too fine a distinction, if not a deviation from accuracy, to say there is a difference in assigning contract rights to a third party or in extinguishing them between the third party and the obligor. In *General Artists* the consideration moved from MCA to GA, and no readily observable benefits accrued to Sinatra. The transaction was made so that MCA could be put into as nearly as possible the same position that GA had occupied before the transaction was consummated. Moreover, there is no reason to assume, as was done by the court, that this contract was so personal in nature that it could not be carried out by another booking agent. In fact this is precisely what happened.<sup>27</sup> Because consent by the obligee changes the rule that personal contracts are not assignable,<sup>28</sup> and since Sinatra consented in writing to the assignment, there is no barrier to the assignment except chance words which were used in the contract. But the case should not turn upon the point that the parties happened to use both the words "sale" and "cancel" in the same contract.

There surely cannot be that efficacy in lawyers' jargon that termination or cancellation or surrender carries some peculiar significance vastly penalizing laymen whose counsel have chanced to use them.<sup>29</sup>

If the court felt bound to hold that this was not a capital transaction, it would have been on safer ground to have said that all GA owned was a right to receive income and that assignment of this right would not convert it into a capital asset.

*Conclusion:* An ultimate payment realized upon a right to receive income will obviously be treated as ordinary income. Thus it follows that a contract right which is nothing more than a right to receive income is ordinarily not a capital asset, and the consideration received for the assignment or cancellation of such a contract will not be allowed capital gains treatment. A person's talent and the capacity to work is a valuable property right, but payment for the use of his talent or capacity to work, or for refraining from the use of either will ordinarily be classified as ordinary income. Therefore, an assignment or cancellation of a contract embodying these elements will not convert it into a capital asset for purposes of taxation. However, with a slight change of facts the taxpayer may be considered a joint adventurer or partner and thus the contract determined to be a capital asset. Too, an exclusive agency contract which does not create a strict

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<sup>27</sup> See *General Artists Corp. v. Commissioner*, 17 T. C. 1517, 1524 (1952) (dissenting opinion).

<sup>28</sup> 4 AM. JUR. 236 (1936).

<sup>29</sup> *McAllister v. Commissioner*, 157 F. 2d 235, 236 (2d Cir. 1946).

employer-employee relationship but requires the rendition of services may be held to be a capital asset, and payment for the termination of such a contract may constitute a sale if the contract is sold as a part of a going business. Yet, when the contract is in the nature of a negative covenant, payment by the covenantor to the covenantee for its cancellation may be said to be a release of the covenant which transfers nothing to the covenantee, thus preventing a sale or exchange. Ordinarily when a transaction is made with a third party, it has a better chance of producing capital gains than a direct settlement with the obligor which cancels, releases, or surrenders the contract. However, an exclusive agency contract which is framed in terms of a negative covenant may not be aided by this fact. But without this fact, consideration received by a tenant for his agreement to cancel the lease is treated as a capital gain.

WILLIAM J. BRIGGS

#### "PURCHASE-MONEY" TRUSTS IN KENTUCKY

In the recent case of *Sewell v. Sewell*<sup>1</sup> the Court of Appeals of Kentucky reaffirmed the rule that under the Kentucky statute prohibiting purchase-money resulting trusts no trust arises when a deed is made to one person and the consideration is paid by another, unless the grantee takes the deed in his own name *without the consent* of the person paying the consideration or unless the grantee, *in violation of a trust or an agreement*, purchases the land with the effects of another person. The court said there must be clear and convincing proof that title was taken without consent of the payor, and held that no trust would arise in favor of decedent's wife where the admissible evidence tended to show that her husband took title with her knowledge and without objection on her part prior to his death.<sup>2</sup> The court expressly refused to reconcile what it called "the apparent conflict

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<sup>1</sup> 260 S.W. 2d 643 (Ky. 1953).

<sup>2</sup> It was held that the only competent evidence was testimony concerning statements made by the deceased to several neighbors. The testimony of the wife that she furnished funds to her husband was held incompetent on the theory that it concerned a confidential communication between husband and wife and a transaction with a person since deceased both within the inhibition of the Civil Code of Practice.

In such situations the wife has been held to be competent on the ground that her rights arose by operation of law and not from any transaction with her husband. 26 AM. JUR. 731 (1940). However, usually a cestui que trust or one attempting to impress a trusteeship on another is incompetent to testify to a transaction with a person since deceased where his interest would be directly affected by the result. 70 C. J. 124 (1935).